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RBC WEALTH MANAGEMENT

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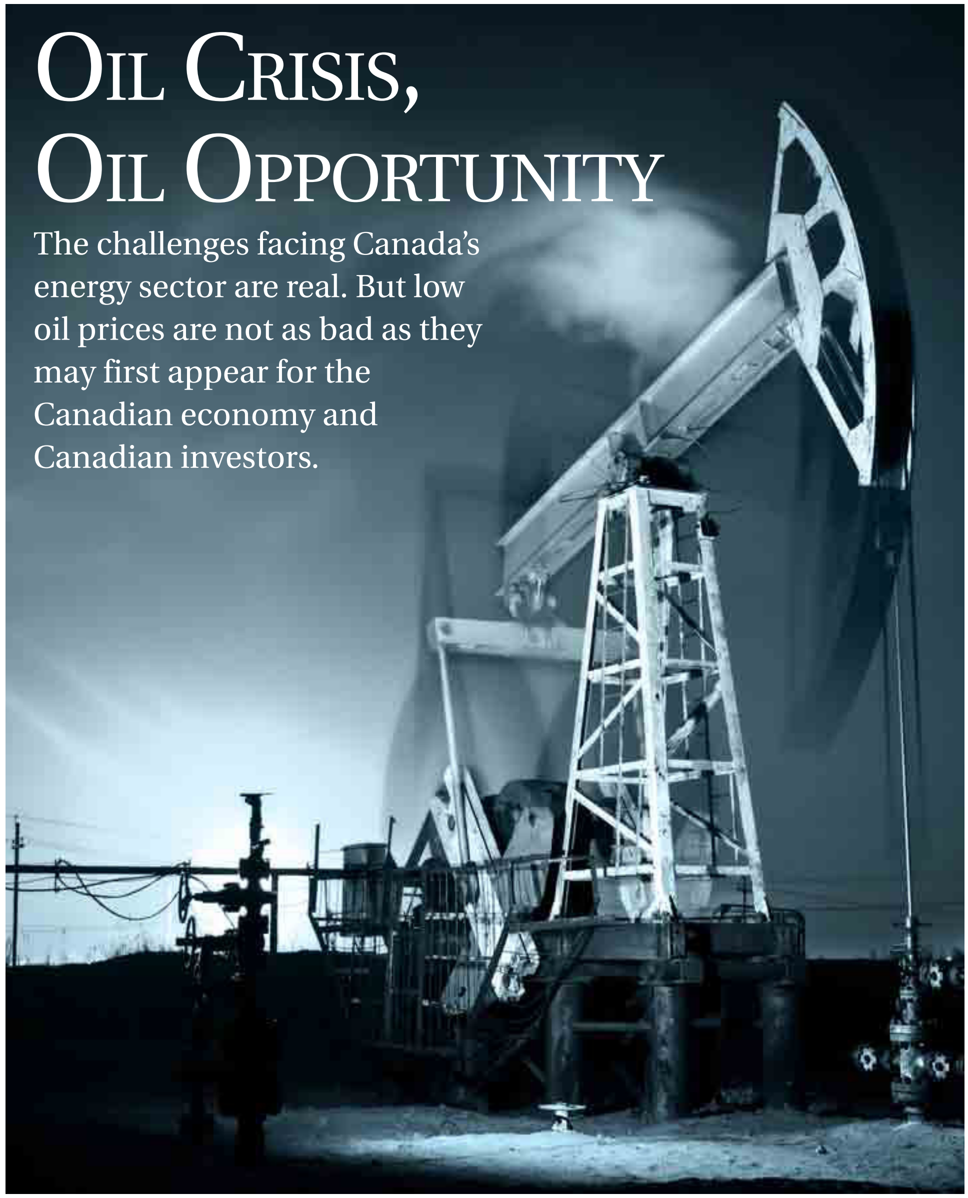
SPECIAL REPORT

Chris Durward
CFP, CIM
Vice President & Portfolio Manager
416-974-1918
chris.durward@rbc.com

Janice Ng
FMA
Associate
416-974-7192
janice.ng@rbc.com

2345 Yonge St
10th Floor
Toronto, ON



Oil Crisis, Oil Opportunity

The challenges facing Canada's energy sector are real. But low oil prices are not as bad as they may first appear for the Canadian economy and Canadian investors.

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Special
Report

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All values in U.S. dollars and priced as of market close, December 16, 2014, unless otherwise stated.

The Big Picture

Canada and oil have become synonymous in many ways as the country's conventional and vast tar sands reserves have entrenched the notion that as oil goes, so goes Canada. But reality is often quite different from the prevailing narrative.

While oil is important to the Canadian economy and to its stock and bond markets, this importance is often overstated. In many ways, the ebbs and flows of the global economy and especially that of the U.S., are of far more importance in determining the trajectory of the Canadian economy than is oil.

This special edition of *Global Insight* is focused on assessing what the slide in the crude price means for the Canadian economy and stock market.

Why Oil Collapsed

A combination of supply and demand factors sparked the rapid decline of oil.

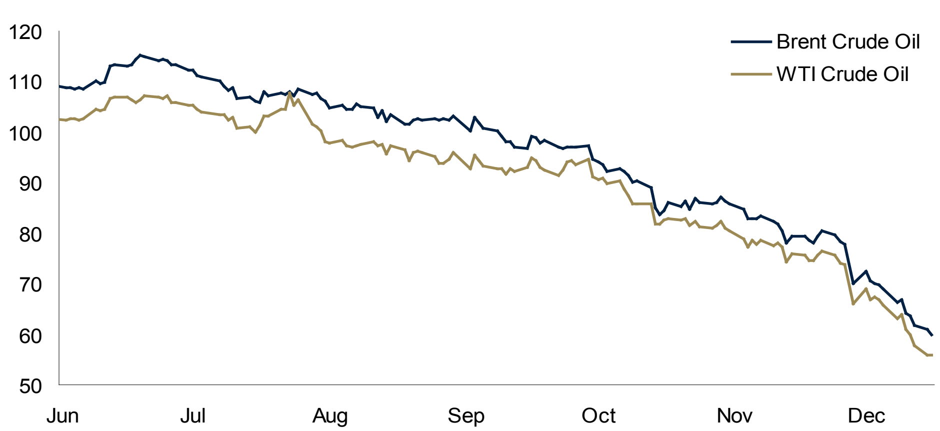
U.S. shale oil production jumped 25% in 2014 and has risen 300% since 2011. As a result, total U.S. oil and liquids production now exceeds that of Russia and Saudi Arabia—and continues to track well ahead of even the most optimistic estimates. On top of this, a 200% increase in Libyan production, which had been largely offline since the Arab Spring, further exacerbated the growth in supply.

Against this backdrop, the International Energy Agency has reduced its world oil consumption forecast repeatedly with slowing Chinese growth (one of the primary sources of increased oil demand for much of the past decade), European stagnation, and the latest—weak Russian demand—the primary drivers.

Perhaps the last straw in this supply/demand dynamic played out in late November, as OPEC, which supplies about one-third of the world's oil, proved unwilling to reduce production, calling into question the Cartel's determination/ability to maintain oil prices above a certain level.

Financial factors also gripped the oil market and energy securities, exacerbating the sell-off in December. Persistent U.S. dollar strength has played an important role,

Crude Oil Price per Barrel ($)



Source - RBC Wealth Management, Bloomberg; data as of 12/16/14 rising 9.3% on a trade-weighted basis since the July peak in WTI crude. When the dollar rises, commodities often fall.

On the securities front, tax-loss selling has also been at work as investors have looked to generate losses in certain securities—in this case, oil and gas bonds and shares—in order to offset taxable gains realized in others.

Positives Outweigh the Negatives

While the collapse in oil prices has been scary at times, we would note that the consequences for the global economy will be mostly positive. Energy is one of the biggest costs for both consumers and businesses. Any decline in oil prices will tend to increase disposable income that can be used for discretionary spending, debt reduction, and investment.

RBC Global Asset Management estimates low crude prices should boost global GDP by at least a few tenths of a percent, as consumers and businesses have more money to spend. Most major economies should see an increase of 20–70 basis points in growth.

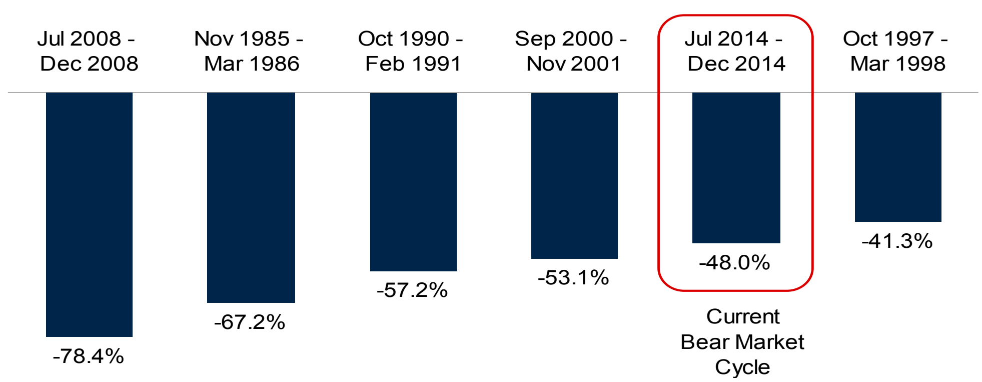
Low crude oil prices could contribute up to 0.5% to eurozone GDP in 2015. That would be a non-trivial boost considering the region has barely grown in the past year.

The IMF estimates that a 40% decline in oil could add at least 1.3% to Japan's GDP after two years as the country imports all of its oil. Again, in an economy that has struggled to grow for many years, a boost of this magnitude would be significant.

The U.S. should be among the biggest beneficiaries. Every 10% decline in crude usually brings about a 0.1%–0.2% increase in U.S. GDP growth, according to RBC Economics. Put another way, the 32% decline in gasoline represents up to a $125B tax cut for consumers, which equates to almost $1,100 per household. To us, this makes it all the more likely the U.S. economy will grow 3%+ in 2015; achieving this level for the first time in a decade.

While the oil collapse is bad news for the U.S. energy sector (which accounts for less than 8% of total capital spending), many other sectors should benefit greatly including transportation (airlines, rails, and truckers), retailers, consumer product

Severe Crude Oil Bear Markets Since 1984 (WTI in $)



Source - RBC Wealth Management, Bloomberg; data for current cycle through 12/16/14 companies, auto manufacturers, non-energy manufacturers, and specialty chemical companies, among others. The same goes for those industries in other countries.

For Canada, the *direct* impact of oil's decline will negatively affect the economy. But once *indirect* impacts are factored in, such as benefits from the boost to the U.S. economy (roughly 75% of Canadian exports are consumed by the U.S.) and the weaker Canadian dollar, the total hit to Canadian growth should be minimal, perhaps even net positive depending on where crude oil stabilizes.

Canadian oil sands projects would likely proceed as planned, just as they did when crude oil prices plunged during the Great Recession in 2008–2009.

On balance, we believe these broad-based economic positives will outweigh the negatives borne by the global energy industry.

Adjust Expectations

Investors should resist the temptation to try to call a bottom in oil. Once a market has collapsed, it usually takes time—at least several months, perhaps longer—for it to stabilize and form a base. Patience is warranted. The days of $100 oil are in the rear view mirror for now, and that level may not be regained for some time. "Cheap oil" in the range of $50–$70 per barrel could be the norm for 2015 and possibly longer.

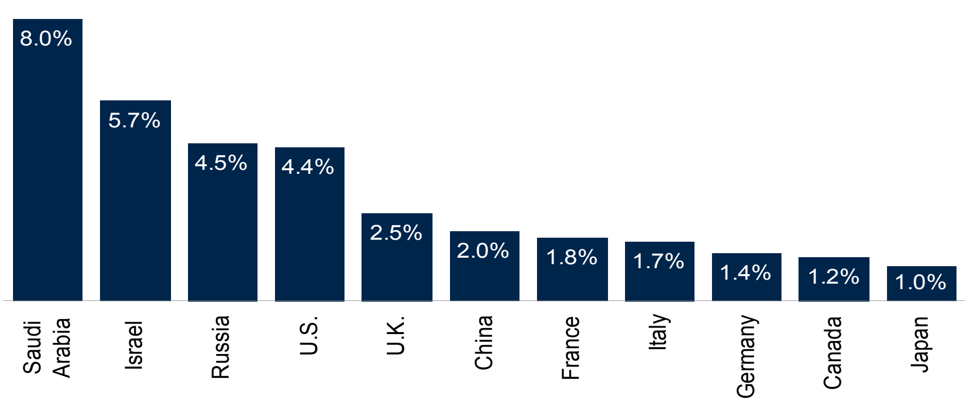
The industry will need time to adapt. Some overextended, distressed companies may end up having to sell assets at fire-sale prices or could even go under. We're also likely to see additional cuts to capital spending programs and decreased shale oil production growth.

Ultimately, it is likely to take production cuts by OPEC and other major producers such as Russia to bring supply back into balance and the market to fully stabilize.

RBC Capital Markets' commodity specialist asserts that Saudi Arabia cannot afford a protracted, multi-year price war against the U.S. shale oil industry as its social spending commitments and defense budget are just too high. Even at $75–$80 per barrel crude oil, far above where we are at present, the Kingdom would be at risk of depleting its financial reserves in just a few years. Several other OPEC members are in an even worse financial position.

Saudi Arabia's High Defense Budget May Limit Its Ability to Endure Low Oil Prices

Military Expenditures as % of GDP - Select Nations



Source - RBC Wealth Management, CIA World Factbook; 2012 data

If prices fail to bounce sufficiently in the first quarter of 2015, RBC Capital Markets believes OPEC will withdraw barrels from the market in the second quarter. If OPEC cuts production by one million barrels per day, or 3%, our economist estimates that could theoretically lift crude oil prices by 10%–25%.

In the meantime, it may take more time for energy securities to adjust to the new lower price regime.

Global institutional investors probably are not done selling exposure to dollar- and euro-denominated high yield energy bonds. In addition, equity investors have yet to separate the wheat from the chaff. There could be more pain in the near term in both asset classes.

But, ultimately, this should create opportunities. The U.S. economy is accelerating and most developed economies are not at risk of falling into recession, nor are China or India. So, growth in crude oil demand will likely continue to grind slowly higher. As supply comes back into balance, energy companies should be able to capitalize.

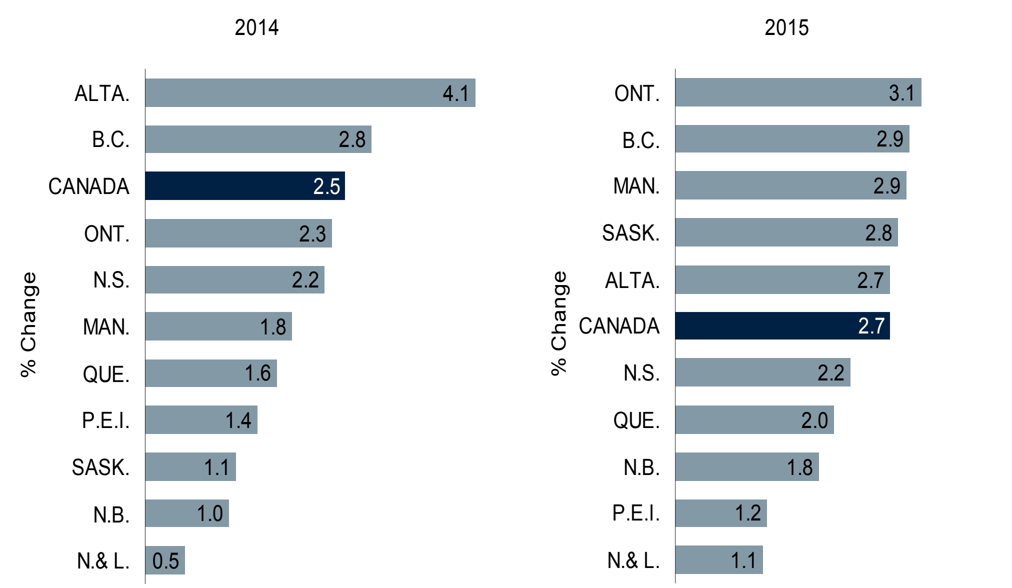
Against this backdrop, we believe both opportunities and headwinds abound for Canadian-based investors. While the decline in oil prices impacts Canada more than most developed economies, this impact tends to be more regionally focused. And while the energy sector of the S&P/TSX (as well as the bonds of some of these firms) is down sharply and faces many near-term questions, other areas of the stock and bond markets stand to benefit. In this special edition of *Global Insight*, we will address those opportunities and headwinds.

A Surprisingly Balanced Impact

The effects of the drop in oil prices on the Canadian economy will be mixed, in our opinion. On the one hand, it is clearly negative for the oil-producing provinces—Alberta, British Columbia, and Saskatchewan. RBC Economics estimates that, all else equal, the decline in oil could subtract as much as 0.8% from Alberta's economic output, dropping expected growth to about 2.7% from about 3.5%. The length of the downturn would also matter—a prolonged oil slump could potentially mean a much greater cumulative hit to the economy.

On the other hand, some provinces would benefit—the manufacturing-heavy provinces of Ontario and Quebec in particular. RBC Economics estimates that, all else equal, the drop in prices would equate to about a 0.5% lift for both. Some of this would depend on what impact the drop in oil prices has on the loonie: the bigger the decline, the greater the improvement in manufacturing competitiveness. The drop in oil prices could drive a shift in growth patterns for the Canadian economy as a whole (see chart) as Ontario potentially emerges as the growth leader in Canada. Big oil-producing provinces remain steady growers, albeit at a slower pace than in recent years.

Real GDP Growth (2014 & 2015)



Source - RBC Capital Markets

As mentioned earlier, lower oil prices act like a tax cut for consumers everywhere, and the Canadian economy would broadly feel the benefit of it. Further, a weaker loonie means Canadians are more likely to shop and travel within Canada versus recent years when U.S. travel, and especially U.S. shopping, became a measurable drag on domestic growth. One would also expect some pick-up in travel from Americans looking to come to Canada to take advantage of the increased purchasing power of the U.S. dollar, potentially adding to Canadian growth. Recent cross-border traffic statistics suggest this is already happening.

More Weakness Possible

The Canadian dollar has come under significant selling pressure against the U.S. dollar in recent months concurrent with a sharp decline in oil prices.

Exchange rates are in large part driven by differential interest rates between currency areas (e.g., eurozone, Canada, and the U.S.), but interest rates in a particular region are actually a function of other factors including the rate of inflation, pace of economic growth, and balance of trade. Currencies often react to changes in commodity prices, but arguably, currency movements actually reflect a broader view on the economic effects and monetary policy implications of lower commodity prices.

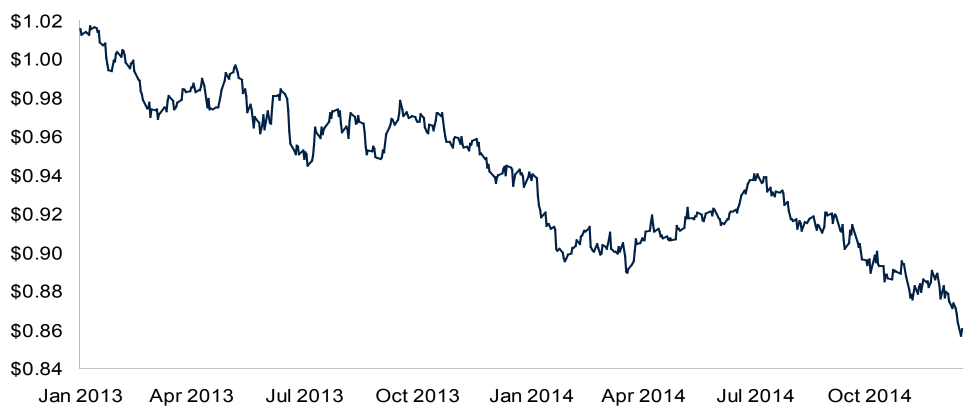
The broader narrative of the Canadian dollar versus the U.S. dollar over the last 24 months can be characterized as steady and consistent weakness.

The Canadian dollar slumped nearly 10% versus the greenback in 2013 despite WTI hovering close to US$95/bbl for much of the year (see chart). This weakness can be attributed to evidence of rebounding U.S. economic growth and rising expectations that the Federal Reserve would hike interest rates while the Bank of Canada (BOC) would stay in a holding pattern.

This sentiment spilled over into 2014 and was, in fact, further exacerbated when BOC Governor Stephen Poloz struck a dovish tone that suggested accommodative monetary policy would remain in place in an effort to spark more balanced growth in the Canadian economy.

Canadian Dollar Spot Rate

USD per CAD, 2013-2014



Source - RBC Wealth Management, Bloomberg, data through 12/16/14

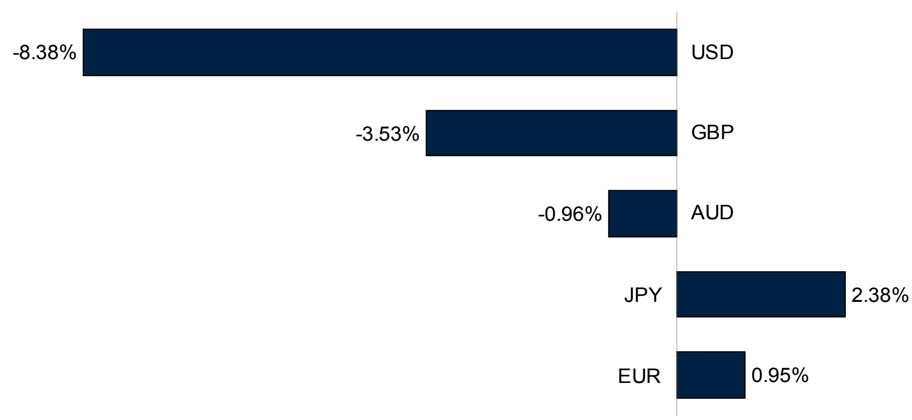
The Canadian dollar recouped nearly half of its losses against the U.S. dollar by mid-2014, but then surrendered all of these gains and then some as the slide in oil prices commenced. The move in oil prices can be viewed as the currency markets' view on monetary policy in Canada versus the U.S., which we reiterate is a function of different economic growth trajectories.

Canadian Dollar

We believe it is inevitable that oil producers will cut back on capital expenditures should lower oil prices continue to linger, which would ripple through many parts of the economy and crimp growth. This lower level of growth in turn could force the BOC to slow or even hold off on interest rate increases from current levels. The market's anticipation of lower growth in Canada concurrent with expectations that the Fed is inching closer to a rate hike in mid-2015 is likely behind the latest move down in the Canadian dollar versus the greenback.

The implications for the Canadian dollar against other currencies ex-the U.S. dollar in an environment of falling oil prices is less clear. The chart below highlights how the Canadian dollar has eked out a modest gain against the euro in 2014, which (again) is a function of divergent interest rate polices in place given different economic conditions.

CAD vs. Global Currencies (2014)



Source - RBC Wealth Management, Bloomberg; data through 12/16/14

While the BOC may choose to hold rates steady, the European Central Bank has embarked on an ambitious stimulus effort that includes asset purchases to kick start growth and ward off deflation. Similarly, the Canadian dollar has recorded solid gains against the Japanese yen in 2014 given the Bank of Japan's significant stimulus efforts to rejuvenate that country's moribund economy and stimulate some level of healthy inflation.

The takeaway from our perspective is that the Canadian dollar is unlikely to depreciate universally against major global currencies as a direct result of the decline in oil prices as there are so many economic factors at play in the determination of each currency pair.

Overall, we believe more weakness versus the greenback is likely in 2015 as interest rate policies diverge. A sharp recovery in oil and concurrently a better growth path for the Canadian economy could stymie this, but for now we believe the trend remains down. On a more global basis, we expect the loonie to hold in better as the relative growth rate of Canada should hold up quite well when compared to other developed economies such as the eurozone and Japan.

A Mixed Bag

The drop in oil prices will affect the interest-sensitive subsectors to varying degrees. Lending to oil and gas firms could slow, which would hit the banks. Loan losses may rise, which would impact both the banks and the life insurance companies (lifecos), which own large bond portfolios.

Furthermore, oil rich provinces, such as Alberta, could see some economic weakness, which could affect real estate-focused businesses through higher vacancies and potentially project cancellations.

Overall, we think the risks are manageable across the spectrum.

Banks

Overall, we consider Canadian banks to be well positioned to navigate through a softer oil price environment, with limited credit exposure and a potential decline in capital market activities that appears manageable.

Lower oil prices are likely to impact Canadian banks in four ways:

- Weaker capital markets revenue (trading, advisory, and underwriting)
- Slower loan growth, particularly in Alberta
- Higher credit losses
- Flow of investor funds

The most immediate and material impact is likely to come from lower **capital markets revenue**. While disclosure is limited, most industry sources suggest that 20%–25% of underwriting revenue comes from the energy sector.

National Bank of Canada (NA) has a particularly strong presence in energy across all wholesale business lines and may be more impacted by a slowdown in energy markets than its peers. We would also note that National Bank has the highest overall exposure to capital markets among the Canadian banks.

National Bank Has the Highest Portion of Capital Markets Earnings

2014 ($M)	Capital Markets Earnings	Total Earnings	Capital Markets % Total Earnings
Bank of Montreal	1,080	4,277	25%
Bank of Nova Scotia	1,481	6,771	22%
Canadian Imperial Bank of Commerce	913	3,573	26%
National Bank	609	1,484	41%
Royal Bank of Canada	2,055	9,004	23%
The Toronto-Dominion Bank	813	7,876	10%
Total	**6,951**	**32,985**	**21%**

Source - RBC Capital Markets, Company reports

We believe the effect on **loan growth** is likely to be limited, at least for the larger banks, as the energy sector accounts for less than 10% of total loan books. Implications for **credit losses** should also be muted, as these tend to closely correlate to unemployment—only 2% of Canada's labour force is employed by the energy industry.

Large Banks Have Relatively "Low" Weighting to Energy Loans

$M	Total Energy Loans	% of Total Loans	% of CET1 Capital
Bank of Montreal	5,943	1.9%	26.5%
Bank of Nova Scotia	12,800	3.0%	37.9%
Canadian Imperial Bank of Commerce	5,230	2.0%	35.8%
National Bank	3,200	3.3%	53.5%
Royal Bank of Canada	9,615	2.1%	26.4%
The Toronto-Dominion Bank	3,635	0.8%	11.7%
Total	**40,423**	**2.0%**	**28.0%**

Source - RBC Capital Markets, Company reports

The **flow of investor funds** issue is harder to gauge, but no less important, in our view.

Canadian banks tend to be popular investment vehicles for international investors. However, when the Canadian economy is being buffeted by headwinds, these same investors will often turn tail and exit their positions en masse, which can lead to sharper share price declines than fundamentals might suggest.

Names that bear watching include:

- **Canadian Western Bank** (CWB): Among the Canadian banks, Canadian Western Bank has the highest exposure to commercial lending (85% of the loan book) and is the most exposed to Alberta's economy (about 50% of its business).
- **Bank of Nova Scotia** (BNS): While Bank of Nova Scotia has low exposure to oil and gas lending (as a percentage of its loan book and as a percentage of its common equity) it has significantly more exposure to emerging markets (EM) than its peers. EMs tend not only to be sensitive to swings in commodity prices, but also tend to struggle during periods of U.S. dollar strengthening.
- **National Bank** (NA): Given the aforementioned exposure to capital markets, a prolonged downturn in oil prices could weigh on National Bank's business model.

Insurance

We believe the Canadian lifecos are comparatively better positioned than the banks to weather sustained weakness in crude oil.

With respect to investments, exposure to the oil and gas industry is mostly limited to corporate bond holdings. While mark-to-market losses could accrue as bond issues are downgraded, prior experience suggests permanent impairments are likely to be manageable once the stressed period has run its course.

It is worth noting that **Manulife Financial Corp.** (MFC) maintains the highest investment portfolio weighting towards the oil and gas industry, in addition to having a small allocation to direct investments in oil and gas properties. From a business standpoint, the lifecos typically enjoy a greater level of global diversification relative to the banks, which further insulates them from a disruption in domestic economic growth.

Within property and casualty (P&C), **Intact Financial Corp.** (IFC) has manageable exposure to Western Canada with slightly over 20% of premiums written originating in Alberta and British Columbia.

Should the Western Canadian economy decelerate, Intact's operations in the region could slow. But we view this as a manageable headwind that should be offset by operations in provinces that will likely benefit from lower oil prices (i.e., Ontario and Quebec, which represent over 70% of Intact's business).

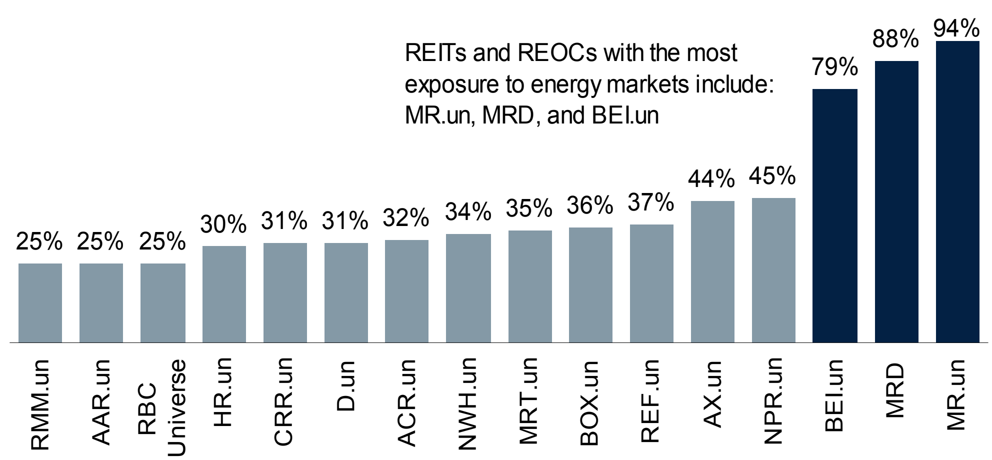
REITs and REOCs

We believe a protracted period of soft energy prices is necessary before underlying fundamentals of real estate investment trusts (REITs) and real estate operating companies (REOCs) would be impacted.

Companies most exposed to energy producing provinces include **Melcor REIT** (MR.un), **Melcor Developments** (MRD), **Boardwalk REIT** (BEI.un), and **Northern Property REIT** (NPR.un).

Energy Market Exposure Overview

REITs and REOCs with 25% or more estimated NOI or earnings exposure to energy-centric markets



Source - RBC Capital Markets, Company reports

Some of these companies should be net beneficiaries from declining crude oil prices. Retail landlords generally have modest exposure to energy-focused economies, with an average net operating income exposure of 19%.

Specifically, **RioCan REIT** (REF.un) has the least exposure (11%) while **Crombie REIT** (CRR.un) has the most (31%). Even in energy-centric markets, 2015 retail sales growth may weaken, but long-term leases should offer stability to landlords. Elsewhere, consumers in all regions should have more disposable income, thus benefiting the retail tenants.

Outside of retail, RBC Capital Markets also notes that **Leisureworld Senior Care Corporation** (LW), **Granite REIT** (GRT), and **WPT Industrial REIT** (WIR.U) have no exposure to energy-focused markets.

Utilities

We expect changes in Government of Canada 10-year bond yields to have a greater influence on the performance of the utility sector than lower oil prices.

However, the risk of an extended period of lower oil prices is likely to weaken demand growth for electricity in Alberta. The power market in that province is currently well supplied and its base load capacity is expanding with the commissioning of the 800MW Sheppard Energy Centre.

Power prices are already weak in Alberta and are expected to remain weak in 2015. A slower pace of economic growth and potential spending deferrals on oil sands projects could result in a longer-than-expected period of weak power prices.

The utility companies most exposed to Alberta's power prices are **Capital Power** (CPX) and **TransAlta** (TA).

On an unhedged basis, a CA$10/MW change in power prices impacts the 2015 earnings of Capital Power and TransAlta by about 50% and 70%, respectively. These companies have substantial hedging in place to shield against this exposure. But as hedges roll over, they offer less protection in the context of a longer-term market lull.

Telecommunications

Broadly speaking, the telecom group is exposed to oil prices tangentially as it relates to their capital spending, which is largely denominated in U.S. dollars. To the extent that oil price weakness is coupled with Canadian dollar weakness, this could be a small potential headwind for the industry. However, this risk is mitigated by foreign exchange hedging programs.

We believe the challenges for the Western-based telecom companies, **TELUS** (T) and **Shaw Communications** (SJR.B), should be manageable. Alberta accounts for just over 20% of TELUS' wireless subscribers, but it is unclear how many of those are related to the oil industry. With national coverage in its wireless platform, the company should be able to handle any headwinds from lower crude oil prices.

Despite Shaw's Western base, direct exposure to softer oil prices will likely be minimal. We understand that major energy companies tend to have their telecom services provided by the large incumbents. As such, data hosting should be a secular tailwind for Shaw irrespective of lower crude prices.

Conclusion

Overall, we believe the risks to the interest-sensitive subsectors are manageable. Should the slump in oil prices last for an extended period of time, some of the above assumptions would likely need to be recast, but even then, we believe that most businesses are well positioned to withstand even a prolonged downturn in oil prices.

More Cash to Spend

Broadly speaking, consumer stocks have minimal direct exposure to oil. However, consumer businesses tend to be affected indirectly by energy prices in two ways:

(1) The impact on disposable consumer incomes; and

(2) The effect of changes in the Canadian dollar.

Lower-income households tend to spend a disproportionate amount of their after-tax incomes on gasoline and home heating costs. Thus, as prices at the pump decline, it frees up income to spend on items that there might otherwise be no room for in the household budget.

Falling Fuel Prices Should Provide an Outsized Benefit to Lower-Income Cohorts

	Pre-Tax Income		
	<50K	>50K	Average
Estimated Avg. After-Tax Income	$22,624	$85,827	$54,286
% of Households	49%	51%	
Residential Energy	$1,832	$2,642	$2,246
Transportation Fuel	$2,606	$4,369	$3,506
Total Energy Costs	$4,438	$7,011	$5,752
% of After-Tax Income	20%	8%	11%
% in 2001	12%	5%	7%

Source - Energy Cost Impacts on American Families

Canadian Dollar

The decline in the Canadian dollar, which has at least in part stemmed from the fall in energy prices, is a bit of a double-edged sword. On the one hand, the weaker loonie will hurt businesses that have a significant amount of U.S. dollar costs. On the other hand, those Canadian businesses that have meaningful U.S. operations (i.e., U.S. dollar revenues) will tend to benefit as the translation of these U.S. revenues back to Canada will benefit. Further, to the degree that Canadians shop less abroad because the loonie has less purchasing power and, by extension, shop more at home, Canadian-based consumer businesses would benefit.

Impact on Canadian Consumer Businesses

Increased Demand

Businesses that gear toward lower-income households such as **Dollarama Inc.** (DOL) and **Canadian Tire Corporation Limited** (CTC.A) should see increased demand. In addition, purely discretionary businesses such as **Restaurant Brands International Inc.** (QSR), which owns Burger King and Tim Hortons, and **Cineplex Inc.** (CGX), Canada's largest theater chain, should also see increased traffic. Businesses that gear toward U.S. travelers, who are likely to travel more to Canada as the loonie weakens, should also benefit, with **Whistler Blackcomb Holdings Inc.** (WB) a notable example.

Increased Costs

While DOL and CTC.A should see increased demand, we think this will be offset by increased costs. Both companies source about one-half of their goods overseas with much of this priced in U.S. dollars. RBC Capital Markets believes the negative impact will be muted for both retailers; however, there is likely to be some cost increases. RBC Capital Markets also notes that grocers such as **Metro Inc.** (MRU) and **Loblaw Companies Ltd.** (L) would also potentially feel some drag as much of their produce (about 10%–15% of sales) is sourced in U.S. dollars.

Translation Benefits

Those consumer businesses that have a significant amount of their business in the U.S. would be beneficiaries of the weakening loonie. **Saputo Inc.** (SAP) generates about one-half of its operating income in the U.S., but reports in Canadian dollars. RBC Capital Markets estimates that every $0.05 decline in the loonie adds about 3% to SAP's earnings. **Restaurant Brands International** (QSR) would also benefit on this front with more than 70% of its revenues coming from outside Canada.

Lower Fuel Costs Offset by Demand Decline

Most industrial businesses have at least some exposure to the commodity space, either directly through sales to commodity businesses or indirectly through transport. Thus, with few exceptions, there is going to be some negative impact from the decline in oil prices and the potential negative drag this could have on volumes and future project development. Some businesses are affected more than others—both positively and negatively.

Businesses We Believe Stand to Benefit

- **Trucking:** Companies such as **TransForce Inc.** (TFI) will tend to benefit in two ways: (1) lower fuel costs (although some of this is typically passed on to customers through fuel surcharges) and (2) a weaker Canadian dollar (as at least some of its revenue is generated in the U.S., while most costs are denominated in Canadian dollars).

- **Airlines:** Jet fuel, at 30% of total expenses, is an airlines' largest operating expense. Even minor shifts in future expectations can lead to significant earnings upside. While a lower Canadian dollar offsets some of the benefit, the net impact is still quite positive. The table below summarizes the sensitivity of **Air Canada** (AC) and **WestJet Airlines Ltd.** (TSE: WJA) to changes in WTI, the Canadian dollar, and yields.

Air Canada and WestJet Have Significant Valuation Leverage to Lower Fuel Prices

		WTI ($1/bbl)	FX (1 cent)	Yield (100 bps)
EBIT Impact (M)	Air Canada	$25	$33	$100
	WestJet	$8	$13	$32
Valuation Impact (per share)	Air Canada	$0.37	$0.49	$1.48
	WestJet	$0.31	$0.50	$1.23

Note: EBIT and Valuation Impact in CAD. Source - Company reports, RBC Capital Markets

Businesses That Could Be Negatively Affected

- **SNC-Lavalin Group Inc.** (SNC): Following the acquisition of Kentz Corporation (announced in June), oil- and gas-related services now generate about one-quarter of SNC's revenues. The company recently noted on its quarterly conference call that it had yet to see any impact from the correction in crude prices on the backlog for Kentz or from its customers.

- **Finning International Inc.** (FTT): Oil sands represent about CA$1B in sales to Finning, or about 30% of the company's Canadian sales. The long lead times associated with Canadian oil sands projects argue against a rapid change in activity levels for developments that have broken ground. However, oil sands producers are likely to adopt a much more cautious approach when it comes to new projects.

- **Railroads: Canadian National Railway Company** (CNR) and **Canadian Pacific Railway Limited** (CP) have some exposure to crude-by-rail and frac sand shipping, which together account for just under 10% of revenues for each company. While current revenue exposure is about the same, it is important to note that most analysts, including at RBC Capital Markets, expect CP to see faster growth in crude by rail and should, as such, be more affected than CNR by the oil price correction.

Sustainability Becomes the Key

The energy industry bears the brunt of the current turmoil in the crude oil complex. To the extent that oil prices continue to languish, we believe negative investor sentiment towards the energy sector will persist for the foreseeable future.

Key areas through which lower oil prices can have an impact on energy-related companies include: dividend sustainability, financial health, and capital investment. However, the impact of declining crude prices on the main energy subsectors differs in degree.

Henry Hub Natural Gas (YTD)

Source - RBC Wealth Management, Bloomberg; data through 12/16/14

WTI (YTD)

Source - RBC Wealth Management, Bloomberg; data through 12/16/14

Oil & Gas Producers

Energy producers are commodity businesses. This means they are largely price takers and are fully exposed to the fluctuations of international crude oil benchmarks such as Brent and WTI.

Integrated energy companies such as **Suncor Energy** (SU) and **Imperial Oil** (IMO) are a relative safe harbour, in our view. This group is generally more insulated from oil price movements because their large downstream refining and retail businesses can help counteract the negative impact of lower oil prices on earnings and cash flow.

Large-cap exploration and production firms, e.g., **Canadian Natural Resources** (CNQ) and **ARC Resources** (ARX), should also hold up better than most thanks in part to their strong balance sheets. To a lesser extent, producers with sizeable hedge books should also be shielded from the vagaries of oil prices in the near term.

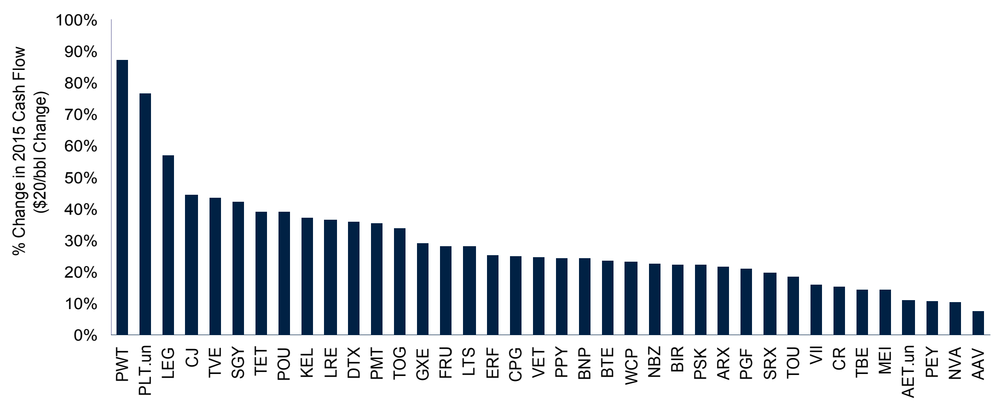
In contrast, medium- and small-sized producers should fare less well than the broader market in an environment of lower oil prices as their businesses and balance sheets tend to be less resilient compared to their large-sized and/or integrated peers. Moreover, access to capital markets for their financing needs could also become more onerous.

In response to high leverage and stretched payout ratios, select oil companies have begun retrenching and paring back capital spending plans. While we have seen the first wave of dividend cuts, more companies could adjust their payouts to reflect the new crude oil reality. Further downward pressure on select producers with a greater degree of uncertainty related to their dividend viability and growth outlook should not be ruled out.

If one entertains the likelihood that we have entered an era of lower oil prices, then among the producers, investors should focus on identifying well managed companies with a proven track record of creating value, low debt levels, and conservative dividend payout profiles.

In that light, the current pullback in energy stocks can be viewed as an opportunity to buy quality franchises at a more affordable price.

Canadian Intermediate E&P – Sensitivity to Oil Prices



Source - RBC Capital Markets estimates, Company reports; data through 12/16/14

Pipeline & Midstream

The midstream subsector includes companies involved in the storage, transportation, and wholesale marketing of refined oil-based products. This subsector tends to be better insulated from commodities' price movements.

These businesses have recently garnered premium valuations in part because of the strong volume growth associated with advancements in drilling technologies and growth in oil sands projects.

A prolonged period of low interest rates has also enhanced their appeal to income- and growth-oriented investors. Though historically low Government of Canada 10-year bond yields should continue to provide some support for valuations, should oil prices remain depressed for an extended period, the risk of project deferrals or even cancellations occurring across the oil and gas subsector would be non-trivial.

This in turn could compress valuations for the pipeline and midstream companies as investors begin to reduce expectations for the subsector's growth rates.

Midstream companies with higher oil exposure include: **Gibson Energy** (GEI), **Inter Pipeline** (IPL), **Keyera** (KEY), and **Pembina Pipeline** (PPL). However, we would expect the entire subsector to face headwinds should crude oil fail to stabilize near current levels. Of the two large-cap pipeline operators, **Enbridge** (ENB) has more oil exposure than does **TransCanada** (TRP). However, both continue to expect oil volumes to grow over the next five years.

Corporate Bond Market Has Been Drilled by Oil

Corporate bond investors are intently watching recent weakness in oil prices, given energy companies have financed operations via significant debt issuance over the course of a multi-year boom in oil prices.

In this piece, we:

- Detail the growth in debt issuance by energy companies in the last decade;
- Distinguish between the performance of investment grade and high yield issuers in recent months; and
- Discuss the potential impact a prolonged period of oil price weakness could have on the broader high yield bond market.

Debt Issuance by Energy Companies: A Growing Part of the Debt Market

Concurrent with rising U.S. oil production has been a surge in debt issuance by oil producers looking to secure low-cost financing. Energy sector issuers have taken advantage of favourable financing conditions at a pace that exceeds issuance from other sectors over the past 10 years, which has resulted in companies from this sector representing a steadily increasing portion of the high yield market. Debt issued by energy companies now represents 16% of the U.S. high yield bond market, versus just 4% in 2004, per a Fitch press release on December 9.

A Growing Concern for Investors

The result of recent issuance trends is that the high yield sector is more exposed to oil prices than had previously been the case. Since early September 2014, yields have been rising on bonds issued by energy companies as investors have demanded more compensation to lend money to these businesses.

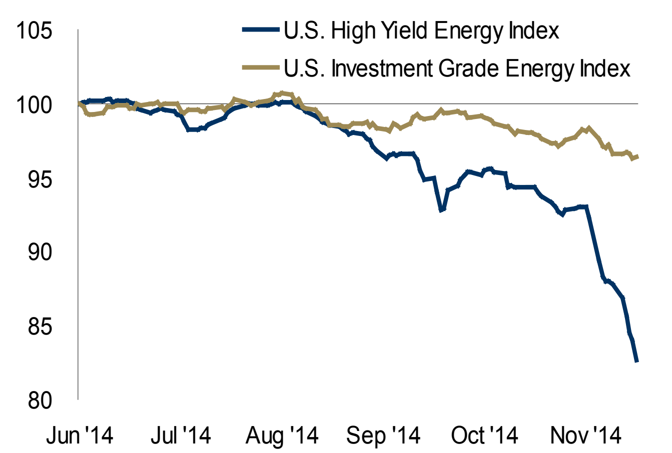
At the same time these yields were rising, the yield levels on government bonds have been trending lower. These wider credit spreads on energy sector bonds reflect their higher credit risk as oil prices have fallen. Should oil prices weaken further, or even stay depressed at current levels for an extended period of time, the ability of some heavily indebted energy companies to meet obligations and refinance maturities could be called into question.

A Bifurcated Market: Resilience in Investment Grade Versus Weakness in High Yield

There is a distinction to be made when it comes to the credit quality of debt issuers in the energy space as investment grade issuers have notably outperformed high yield issuers. Investment grade issuers generally have lower production costs, more diversified businesses, and more flexibility to adjust capital expenditures compared to high yield issuers.

These characteristics, coupled with stronger balance sheets, leave these investment grade issuers better equipped to weather a prolonged period of lower oil prices than their high yield counterparts. Despite this better positioning, many investment grade issuers may need to reduce dividends or raise additional capital should oil prices stay depressed for an extended period of time.

Performance of $100 Invested in Investment Grade Energy Bonds Versus High Yield Energy Bonds



Source - RBC Wealth Management, Bloomberg, data through 12/12/14

Investment grade issuers are better equipped to weather a prolonged period of lower oil prices compared to their high yield counterparts.

The high yield space is a different story simply because issuers do not have the same level of balance sheet strength and financial flexibility as investment grade issuers. We believe a prolonged period of low energy prices may lead to a surge in default rates for lower-quality issuers. Bond investor concerns have been reflected by an approximate 15% price decline and about a 600-basis point yield increase on the Bloomberg USD High Yield Energy Bond Index since late June.

Issuers that have high production costs, such as the newer oil sands projects, and those that are not hedged against moves in oil prices have been among the companies most negatively impacted. Most high yield issuers in the energy sector currently have access to enough liquidity to survive 2015; but, we believe elevated leverage ratios are a cause for concern beyond the next 12 months.

Oil Price Weakness Spurs High Yield Outflows on Fear of a Surge in Defaults

The recent volatility in high yield energy debt has been an unwelcome surprise to many investors new to the high yield bond market. The attractive yields offered by high yield bond funds, in an environment of otherwise depressed yields, have drawn in a significant number of new investors as evidenced by the near $72B that has flowed into high yield funds in North America since 2009.

Investors in this asset class have enjoyed unusually steady returns over an extended period of time characterized by low volatility and low default rates that may have masked the risk inherent in these funds. A prolonged period of low oil prices could lead to a surge in default rates within the high yield sector, which would lead to further underperformance by high yield bond funds.

Non-Energy High Yield Names Also Impacted, Creating Buy Opportunities

The approximate 7% decline experienced in the high yield bond market since June, triggered by lower oil prices, has led to an uptick in fund redemptions. This has left many fund managers needing to raise cash. Liquidity in the high yield market is typically thinner than it is in the investment grade market, but it can prove to be especially elusive when there is a sell-off like the one we have seen over the past several months.

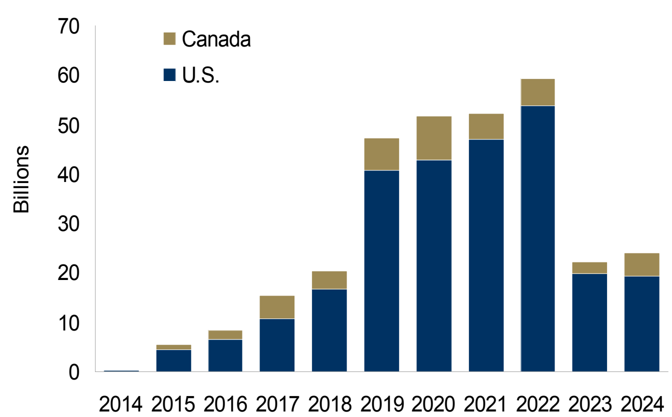
Recently, we have observed that many high yield bonds that stand to benefit from lower oil prices or have little or no exposure to the energy market have also been under pressure as fund managers need to sell their more liquid holdings to meet redemptions. This situation is exacerbated by new capital rules that limit the willingness of banks to hold high yield bonds on their balance sheets. We believe that investors should look to take advantage of the improved valuations on bonds issued by companies in the consumer staples and consumer discretionary sectors.

A Potential Silver Lining: A Manageable Near-Term Maturity Profile

There is a silver lining in the fixed income story for most issuers, even high yield issuers, in that many possess a favorable maturity profile. The low interest rate environment of the last five years has provided the opportunity for investment grade and high yield borrowers to issue longer dated bonds and term out maturity profiles on favorable terms.

Accordingly, few companies require additional funding until 2016 and many have no maturities for the next four to five years. We believe this means that most companies can endure a transitory period of depressed oil prices and have time to weigh key strategic decisions should we be in for a prolonged period of lower oil prices.

Maturity Schedule for High Yield Energy Bonds



Source - RBC Wealth Management, Bloomberg, data through 12/12/14

Few companies require additional funding until 2016, and many have no maturities for the next four or five years.

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Jim Allworth – Co-chair; Investment Strategist, RBC Dominion Securities Inc.

Maarten Jansen – Head, Investments & Trading, RBC Wealth Management Global Wealth Services Group, RBC Dominion Securities Inc.

Mark Allen – Portfolio Advisor, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Rajan Bansi – Head of Fixed Income Strategies, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Matt Barasch – Head of Canadian Equities, RBC Wealth Management Portfolio Advisory Group, RBC Dominion Securities Inc.

Craig Bishop – Lead Strategist, U.S. Fixed Income Strategies Group, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

Kelly Bogdanov – Portfolio Analyst, RBC Wealth Management Portfolio Advisory Group, RBC Capital Markets, LLC

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Authors

RBC Wealth Management Portfolio Advisory Group
RBC Dominion Securities Inc.

Mark Allen – Portfolio Advisor; mark.d.allen@rbc.com
Alana Awad – Fixed Income Portfolio Advisor; alana.awad@rbc.com
Tasneem Azim-Khan – US Portfolio Advisor; tasneem.azim@rbc.com
Rajan Bansi – Head of Fixed Income Strategies; rajan.bansi@rbc.com
Matt Barasch – Head of Canadian Equities; matt.barasch@rbc.com
Lindsay Brent – Associate Advisor; lindsay.brent@rbc.com
Jean-Francois Dion – Portfolio Advisor; jean-francois.dion@rbc.com
Dominick Hardy – Portfolio Advisor; dominick.hardy@rbc.com
Eric Lafortune – Fixed Income Portfolio Advisor; eric.lafortune@rbc.com
Patrick McAllister – Associate Advisor; patrick.mcallister@rbc.com
Mikhial Pasic – Fixed Income Portfolio Advisor; mikhial.pasic@rbc.com
Joseph Wu – Associate Advisor; joseph.wu@rbc.com

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